Internal Revenue Service

memorandum

CC:TL:TS
JROSENBERG

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to: District Counsel, Philadelphia MA:PHI
Attn: Ted Marasciulo

from: Assistant Chief Counsel
(Tax Litigation) CC:TL

subject: [redacted] - Determination of Partnership Items
TL-N-2477-90
CC:TL:TS Rosenberg, Wilson
I.R.C. § 6231
Partnership Items

This memorandum is in response to your request for tax litigation advice dated December 29, 1989.

ISSUES

Whether the disallowance of the interest deduction on the [redacted] partners' notes on the grounds of lack of substantiation and lack of genuine indebtedness is a partnership item, nonpartnership item, or affected item requiring disallowance in a notice of final partnership administrative adjustment or in individual statutory notices of deficiency.

CONCLUSION

Pursuant to I.R.C. § 6231 a partnership item is any item required to be taken into account for a partnership's taxable year to the extent the regulations provide that such item is more appropriately determined at the partnership level than at the partner level.

Under the facts of this case, to the extent the disallowance of the partner's interest deduction is based on lack of substantiation, the issue appears to be a nonpartnership item since the interest deduction is not a deduction of the partnership which flows through to the partners.

To the extent the grounds for disallowance are that the note was a sham, this may be a partnership item since the loans were apparently arranged for and negotiated at the partnership level. In addition, the proceeds of the note were allegedly paid directly to the partnership and the amount and character of amounts contributed to a partnership are defined as partnership items.

The determinations relating to the alleged sham loan transactions and contributions are only directly relevant to the partnership items of the partners' basis and accrued partnership level deductions in the leasing scheme. They may, however, "affect" the determination of whether interest was paid, making the issue an "affected" item. <u>See</u> I.R.C. § 6231(a)(5). Affected items, if merely computational, may be directly assessed following a partnership proceeding. I.R.C. § 6230(a)(1). If additional partner level determinations need to be made, affected item notices of deficiency would have to be issued following the TEFRA proceeding. I.R.C. § 6230(a)(2)(A)(i). It is unclear whether the determinations at the partnership level would also affect the substantiation issue making this an affected item.

Since the character of these issues is not completely free from doubt, we recommend that the non-TEFRA notice of deficiency assert both lack of substantiation and sham as grounds for disallowing the interest deduction. A notice of final partnership administration adjustment should also be issued at the partnership level asserting that the note does not constitute genuine indebtedness.

FACTS

[redacted] is a TEFRA partnership that was formed on [redacted] under the Uniform Partnership Act of the State of New Jersey. [redacted] was purportedly created to lease employees and subcontractors to an operating company, [redacted] ([redacted]).

The transaction involved in this case arose out of an employee lease agreement between [redacted] and [redacted]. Pursuant to the terms of the lease agreement, [redacted] would provide [redacted]. with the use of its employees and independent contractors in the conduct of [redacted].'s [redacted] business for a one year period. The agreement provided that the individuals provided to [redacted] were the employees of [redacted] and that [redacted] would pay all wages, payroll taxes and insurance costs with respect to the employees. As compensation, [redacted] would pay [redacted] of the amount actually incurred for payroll costs under the agreement. This amount was due on [redacted] however, [redacted] could and ultimately did elect to defer payment of this amount for [redacted] years by paying a [redacted] percent annual late charge. [redacted] relied on its accrual method of accounting to deduct the entire amount in the first year, while [redacted] on the cash method of accounting, would take only the [redacted] percent late charge into income. Thus, both entities effectively deducted the employees' salaries and benefits for the first year of the agreement.

The circular financing in this case traveled through four entities or groups. These are identified as follows:

[redacted]. is an operating company incorporated in [redacted] and is involved in transporting petroleum products.

[redacted] is a partnership created to provide employees and subcontractors (i.e. [redacted]) to [redacted]. pursuant to a one year employee lease agreement.

The [redacted] partners are [redacted] individuals and [redacted] partnerships. Generally, the partners contributed [redacted] of their subscribed capital in cash and the remaining [redacted] in notes.

[redacted]. is a closely held finance company created for the purpose of holding notes of the [redacted] partners.

Generally, the employee lease agreement involved circular financing created by passing notes among the parties through a series of endorsements and through offsetting entries.

The initial financing of the transaction began when [redacted]. gave a demand note to [redacted] for $[redacted] at [redacted]% interest (in exchange for a note from [redacted] at [redacted]%) in order to fund [redacted] as a financing source for the partners. Next, [redacted] gave notes to the [redacted] partners in the total amount of $[redacted] (in exchange for notes from the partners) to fund their partnership contributions. The partners directed [redacted] to "pay" the loan proceeds directly to [redacted]. This was accomplished by [redacted] endorsing the [redacted]% note of [redacted]. to [redacted]. [redacted] then advanced this note back to [redacted]. pursuant to the terms of the employee lease agreement as a guarantee to ensure performance on the contract. Thus, the initial note of [redacted]. traveled in a complete circle back to itself.

In the initial year of the transaction, [redacted] billed [redacted]. [redacted]% of the payroll costs as required under the employee lease agreement. However, [redacted]. deferred payment of this amount and therefore, incurred a [redacted]% late charge to [redacted]. The [redacted]% late charge was the only income taken into account by [redacted]. [redacted] would then distribute this amount to its partners who would then pay it to [redacted] as interest on their notes. [redacted], in turn, apparently paid this interest back to [redacted]. on the [redacted]% note, completing a second circle.

In reality, the above-described transaction involved numerous notes travelling in all directions but there is no evidence of any payments on the notes nor any checks, loans or distributions. The transactions are actually evidenced only by circular journal entries adjusting the various accounts of the parties involved in the transaction.

DISCUSSION

The issue in this case is whether the disallowance of the interest deduction on amounts borrowed from an alleged third party lender is a partnership item, affected item or nonpartnership item. Pursuant to section 6221, the tax treatment of any partnership item shall be determined at the partnership level. The term "partnership item" is defined in section 6231(a)(3) as any item required to be taken into account for the partnership's taxable year under any provision of Subtitle A to the extent regulations prescribed by the Secretary provide that such item is more appropriately determined at the partnership level than at the partner level. Partnership item adjustments are included in a notice of final partnership administrative adjustment. I.R.C. § 6223(a)(2).

Pursuant to Treas. Reg. § 301.6231(a)(3)-1(a), partnership items include the partnership aggregate and each partner's share of partnership liabilities (including determinations with respect to the amount of the liabilities and whether the liabilities are nonrecourse), and other amounts determinable at the partnership level with respect to the partnership assets, investments, transactions, and operations necessary to enable the partnership or the partners to determine the investment credit, recapture of the investment credit, and amounts at risk in the activity. Furthermore, the character of an amount received from a partner (for example, whether it is a contribution, loan, or repayment of a loan), the amount of money contributed, and the basis to the partnership of contributed property are partnership items. Treas. Reg. 301.6231(a)(3)-1(a)(4)(i). To the extent that a determination of an item relating to a contribution can be made from a determination that the partnership is required to make, that item is a partnership item. To the extent that the determination requires other information, that determination is not a partnership item. Treas. Reg. § 301.6231(a)(3)-1(c). Partnership items are subject to the period for assessment under section 6229(a) which is a separate period of assessment from the period for assessing nonpartnership items. See Litigation Guideline Memorandum [redacted].

An affected item is any item to the extent such item is affected by a partnership item. I.R.C. § 6231(a)(5). The term "affected item" includes items unrelated to the items reflected on the partnership return, such as the threshold for the medical expense deduction under section 213 that varies if there is a change in an individual partner's adjusted gross income. Temp. Treas. Reg. § 301.6231(a)(5)-1T. Affected items which do not require partner level determinations are neither raised in an FPAA nor a statutory notice of deficiency. Changes in a partner's tax liability with respect to affected items that do not require partner level determinations are included in a computational adjustment subsequent to the partnership proceeding and/or any judicial decision becoming final. See Temp. Treas. Reg. § 301.6231(a)(6)-1T(a).

The term "affected item" also includes any addition to tax or additional amount provided by subchapter A of chapter 68 of the Internal Revenue Code to the extent provided in Temp. Treas. Reg. § 301.6231(a)(5)-1T(d), any assessable penalties under subchapter B of chapter 68, as well as the partner's basis in his partnership interest and the applicable at risk limitation to the extent that they are not partnership items. See Maxwell v. Commissioner, 87 T.C. 703 (1986); Farris v. Commissioner, T.C. Memo 1986-567; Temp. Treas. Reg. § 301.6231(a)(5)-1T.

Penalties and additions to tax require partner level determinations and are subject to the deficiency procedures of subchapter B of chapter 63 of the Code. Certain basis and at-risk adjustments may similarly require partner level determinations, and to that extent, are also subject to the deficiency procedures rather than computational adjustments. Affected item notices of deficiency are subject to the same statute of limitations as partnership items and may not be issued until after a TEFRA proceeding is complete. N.C.F. Energy Partners v. Commissioner, 89 T.C. 741 (1987).

Section 6231(a)(4) states that a nonpartnership item is an item which is (or is treated as) not a partnership item. Nonpartnership items are generally subject to the usual statutory notice of deficiency procedures of subchapter B of chapter 63 of the Code and section 6501 is applicable with respect to the limitations period for assessment and collection.

In the present case, the Service intends to disallow the section 163 interest deduction on the [redacted] partners' notes both because the notes do not constitute genuine indebtedness and for lack of substantiation. The determination of whether the disallowance of this item is a partnership item, nonpartnership item, or an affected item, will determine whether the item will be disallowed at the partnership level in a notice of final partnership administrative adjustment or at the partner level in a statutory notice of deficiency. Furthermore, whether the item is an affected item or nonpartnership item may affect the applicable statute of limitations and whether a notice of deficiency must await the completion of the TEFRA proceeding.

As noted above, Treas. Reg. § 301.6231(a)(3)-1(a)(4)(i) provides that items related to a partner's contribution to a partnership are partnership items to the extent that a determination of such item can be made from determinations the partnership is required to make with respect to an amount, the character of an amount or the percentage interest of a partner in the partnership. The partnership needs to determine the character of an amount received from a partner. Treas. Reg. § 301.6231(a)(3)-1(c)(2). The amount and character of the partners' contribution to [redacted] (and consequently the partners' basis in their partnership interests and limitations on deductions under section 704(d)) are items dependent on the genuiness of the [redacted] partner notes that were contributed to [redacted]. Thus, the character of these notes as genuine indebtedness is a partnership item. The genuineness of the note is also a partnership item on the separate ground that it relates to the sham nature of the overall [redacted] transaction and related partnership deductions. See Treas. Reg. § 301.6231(a)(3)-1(b) (underlying legal and factual determination controlling partnership deductions are also partnership items).

Even though we conclude that the issue of whether the note constitutes genuine indebtedness is a partnership item, it is unclear whether the disallowance of the interest deduction on the partner notes given to [redacted] in exchange for that note on the ground that the partner notes to [redacted] do not constitute genuine indebtedness should be treated as a nonpartnership item or an affected item. While a notice of deficiency would have to be issued in either case, an affected item notice of deficiency could not be issued until a TEFRA proceeding is complete. See N.C.F. Energy Partners v. Commissioner, supra. If the interest deduction is a nonpartnership item and a notice of deficiency is not issued until after the TEFRA proceeding is complete, the period for assessment under section 6501 may expire in the interim.

The disallowance of this item on the theory of lack of genuine indebtedness may be an affected item because it would be affected by a determination that the transactions at the partnership level and related indebtedness were not genuine. The issue could also arguably be a nonpartnership item since the lack of genuine indebtedness may be determined at the partner level, as a loan between a partner and a third party regardless of what happens at the partnership level. We conclude that the issue is an affected item in this context since the same loan which the partners took out and paid interest on was the source of, and paid directly to, the partnership. Since it is unclear under these facts whether the TEFRA provisions require a prior partnership proceeding before the interest deduction may be raised in a partner level proceeding, we recommend that lack of genuine indebtedness should be asserted in a non-TEFRA statutory notice of deficiency. However, we also recommend that, in order to get the sham nature of these notes at issue in the partnership proceeding, a notice of final partnership administrative adjustment should also be issued that disallows the partner's share of partnership losses on the theory that each partner's contribution to the capital of [redacted] is not represented by genuine indebtedness and on the basis that the transactions were a sham. Thus, each partner's section 722 basis in his partnership interest is limited to the amount of cash contributed, and pursuant to section 704(d), each partner is entitled to recognize his share of any loss distributed from the partnership only to the extent of his adjusted basis.

With regard to the theory of lack of substantiation to support the disallowance of each partner's interest deduction, in a normal nontax motivated, bona fide transaction involving a note between a partner and an independent third party creditor, the disallowance of the partner's section 163 interest deduction on this theory would be a nonpartnership item. In that situation, the note that gave rise to the interest expense would relate to the individual partner's debtor/creditor relationship with the third party lender separate and apart from the individual partner's status as a partner in the partnership. Moreover, there would be no accounting for this expense or the loan transaction on the books and records of the partnership that could be used in determining the treatment of this item. We conclude that disallowance of the partners' section 163 interest deduction on the theory of lack of substantiation is more appropriately determined at the partner level as a nonpartnership item. Therefore, in addition to asserting lack of genuine of indebtedness in the non-TEFRA statutory notice of deficiency, lack of substantiation should also be asserted to support disallowance of each partner's interest deduction.

We note, however, that the court's determination of facts and legal conclusions in the partnership proceeding may be sufficiently broad to disallow the interest deductions on the lack of genuine indebtedness theory or on a lack of substantiation theory as a computational adjustment. See Treas. Reg. § 301.6231(a)(3)-1(b). Alternatively, the court's holding may result in one or both of these issues being characterized as an affected item requiring affected item notices of deficiency to be issued after the completion of the TEFRA proceeding.

In light of our recommendation to include the theory of lack of genuine indebtedness in the statutory notices of deficiency (in addition to lack of substantiation) to support disallowance of the partner's interest deduction, if any cases are petitioned to the Tax Court from the notices of deficiency, a motion to dismiss for lack of jurisdiction as to this issue should be filed. The basis for the motion would be that the disallowance of the partner's interest deduction on the theory of lack of genuine indebtedness is an affected item, requiring a partner level determination which must await the completion of the partnership proceeding. See N.C.F. Energy Partners v. Commissioner, supra. Thus, the determination of this item in a statutory notice of deficiency is premature.

By including the lack of genuine indebtedness theory in the statutory notice of deficiency to support disallowance of the item, the Service would be protected if the Court determines that the item is a nonpartnership item. If the Court does determine that this item is an affected item (or that the substantiation issue is an affected item), then pursuant to section 6230(a)(2)(A)(ii), the Service would be permitted to issue an affected item statutory notice of deficiency for these items within one year from the completion of partnership level proceeding. I.R.C. § 6229(d).

Should you have any further questions regarding this matter, please contact Jeff Rosenberg at (FTS) 566-3233.

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